(1) 95-1581

Supreme Court, U.S.
FILED
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NO.

IN THE
SUPREME COURT OF THE UNITED STATES
October Term, 1995

Marion Hurinenko, et al.[1],
Petitioners,

v.

Chevron, U.S.A., et al.
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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March, 1996

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[1] See Appendix A caption for all parties.

QUESTION PRESENTED

Whether the Federal District Court and the U.S. Court of Appeals 8th Circuit correctly applied North Dakota Law in ruling that an oil and gas lessee/ operator who is obligated to pay lessor 1/8th royalty at the well for gas sold could deduct the costs incurred to convert raw gas into a marketable product from the lessors' royalty, when the lease creating the royalty interest is silent as to how post-production costs are to be borne?

TABLE OF CONTENTS

Page

QUESTION PRESENTED i
TABLE OF CONTENTS ii
TABLE OF AUTHORITIES iv
OPINION BELOW 1
JURISDICTION 2
STATEMENT OF THE CASE 2
REASONS FOR GRANTING THE WRIT ... 4

1. The ruling of the United States Court of Appeals Eighth Circuit in its affirmation of the United States District Court undermines a correct interruption of the North Dakota Law and in its erroneous application creates conflict with the oil and gas law in the state of North Dakota and other producing states who look to North Dakota for correct precedent.

CONCLUSION 9

APPENDIX
Appeal from the United States District Court for the District of North Dakota - Opinion of the United States Court of Appeals for the Eighth Circuit ..... A
Memorandum and Order of the United States District Court District of North Dakota ..... B

Denial of Petition for Rehearing United States Court of Appeals for the Eighth Circuit C
Judgment of the United States District Court District of North Dakota ..... D

TABLE OF AUTHORITIES

Cases: Page

Bernhardt v. Polygraphic Company of America,
(VT 1956), 765 S. Ct. 273, 350 U.S. 198,
100 L. Ed. 199. 7

Garmon v. Conoco,
886 P. 2d 652 (Colo. 1994) 4,7

Sternbeger v. Marathon Oil Company,
894 P. 2d 788 (Kans. 1995) 6,7

TXO Production Corporation,
854 P. 2d 880 (Okla. 1992) 6,7

West v. Alpar Resources, Inc.,
298 NW 2 484 (ND 1980) 4,5,6

Page

Constitutional Provisions:

U.S. Const. Art. 4 §1 8

U.S. Const. Amend. 14 8

Page

Statutes:

28 U.S.C. §1245(1) 2

28 U.S.C. §1332 2

28 U.S.C. §1441 2

30 U.S.C. 226 7

North Dakota Century Code 09-07-19 6

IN THE
SUPREME COURT OF THE UNITED STATES
October Term, 1995

Marion Hurinenko, et al.,
Petitioners,

v.

Chevron, U.S.A., et al.
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

The Petitioners respectfully pray that a Writ of Certiorari issue to review the judgment, opinion and denial of rehearing granted by the United States Court of Appeals Eighth Circuit dated November 13, 1995 and January 3, 1996 respectively.

OPINION BELOW

The opinion of the United States Court of Appeals Eighth Circuit is reprinted in Appendix A and the Memorandum and Order of the United States District Court is in Appendix B.

JURISDICTION

The judgment of the United States Court of Appeals Eighth Circuit was entered November 13, 1995 reprinted at Appendix C, and the motion for

rehearing was denied on January 3, 1996 by that Court and reprinted in Appendix D. The jurisdiction of this court is invoked under 28 U.S.C. §1254(1).

STATEMENT OF THE CASE

This action was commenced in the North Dakota State District Court and removed by Respondents to the United States District Court of North Dakota under 28 U.S.C. §1441 as a result of the District Courts jurisdiction over the controversy granted by 28 U.S.C. 1332.

In the Federal District Court both parties moved for Summary Judgment. In this diversity dispute over royalties from an oil and gas lease, petitioners, the lessors, appealed to the U.S. Court of Appeals for the Eighth Circuit from an order granting summary judgment to the respondents. The order was sustained by the U.S. Court of Appeals (App. A, p.3., App. B, p.1.)

Under a 1972 lease, the respondents have the right to mine for oil and gas on petitioners land. Oil reservoirs were discovered on the land in 1977, and the respondents began drilling wells. The oil reservoirs on the petitioners land contained "casinghead gas." As the oil wells pump oil from the ground, this gas is also produced. The casinghead gas at issue in this case is not pure natural gas and thus cannot be transported into natural gas pipelines or sold until the contaminating compounds are removed. Initially, the gas was "flared," that is, burned off at the well. Due to environmental concerns connected with flaring, the North Dakota Industrial Commission

entered an order restricting the oil production until the wells were connected to the gas gathering and processing facility. In 1978, the respondent oil companies completed a processing plant. Most of the gas produced at the plant is sold.

Since the beginning of gas production in 1978, the oil companies have paid the petitioners royalties based on the plant's sales proceeds less costs.

The petitioners claim they are entitled to royalties based on the processing plant's gross proceeds without deduction for processing costs. (App. A, pp. 3-4.).[2]

The oil and gas lease was prepared by the respondents in a printed form and was designed and intended for use in areas where the gas produced by the operating well was "sweet" gas, usable and saleable without processing. The gas produced in this Little Knife field is "sour" gas and is highly poisonous and corrosive until treated.

The "sweet gas" lease provides for royalty payment of 1/8th of the "market price" at the well for gas "used off of the premises." The lease provided for no allocation of costs or payment of any costs by the petitioners. (App. B, pp. 2-4.)

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[2]References to the petitioners appendix are denoted by an appendix A, B, C, or D.

REASONS FOR GRANTING THE WRIT

The ruling of the United States Court of Appeals Eighth Circuit in its affirmation of the United States District Court undermines a correct interruption of the North Dakota Law and in its erroneous application creates conflict with the oil and gas law in the state of North Dakota and other producing states who look to North Dakota for correct precedent.

The United States District Court, District of North Dakota did not certify this question to the North Dakota Supreme Court for determination of whether an oil and gas lessee was required to pay portions of oil and gas costs as stated in the issue.[3]

The North Dakota law in existence, West v. Alpar Resources, Inc., 298 N.W. 2d 484, (ND 1980) was not followed.

On certification of the question of law from the United States District Court of Colorado, the Colorado Supreme Court in Garmon v. Conoco, 886 P.2d 652, (Colo. 1994), at page 657 states the positions of various producing states indicating that Texas and Louisiana have adapted the rule that non-operating

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[3]North Dakota Rules of Appellate Procedure, Rule 47 - Uniform Certification of Questions of Law (a) Power to Answer. The Supreme Court may answer questions of law certified to it by ... a United States district court.....

interests must bear their proportional share of costs incurred after gas is served at the well head. Kansas and Oklahoma have a contrary rule which has developed based on an operator's implied duty to market gas produced under this particular oil and gas lease. Arkansas and North Dakota have reached similar conclusions when considering lease royalty clauses which are silent as to the allocation of post production costs. For that proposition the Colorado court correctly cites West v. Alpar Resources, Inc., supra. The thrust of West is that when a lease does not state otherwise lessors are entitled to royalty payments based on a percentage of total proceeds received by the lessee, without deduction for costs.

The District Court and the Appeals Court engaged confusing interpretation of this lease which was not interrupted in accordance with North Dakota law.

In West v. Alpar Resources, Inc., id., the court cites at page 490 Merrill, in his treatise "Covenants Implied In Oil and Gas Leases" where he asserts as does Kuntz, that a lessee must bear the expense of obtaining a merchantable product with regard to this issue, Merrill states at pages 214-215:

> "If it is the lessees obligation to market the product, it seems necessary to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. No part of the cost of marketing or of preparation for this lease is chargeable to the lessor."

The respondents prepared the lease so they are charged with the duty to include allocations of costs, if any, and if the lease is silent on these provisions or if the lease is ambiguous then the issue should be construed against the respondents. Sternberger v. Marathon Oil Company, 894 P.2d, 788 (Kans. 1995). And in TXO Production Corporation, 854 P.2d, 880 (Okla. 1992), where the United States District Court for the Eastern District of Oklahoma certified a question to the Oklahoma Supreme Court for determination of this issue. Holding that absent contrary lease provisions, an oil and gas lessee has an implied duty to market and that means a duty to get the product to the place of sale in marketable form and includes the costs of preparing gas for market.

North Dakota rules of construction were not applied by the lower federal courts in this case in interrupting the lease. North Dakota Century Code Section 9-07-19 provides that the language of a contract, in cases of uncertainty, should be interrupted strongly against the party who caused the uncertainty to exist. West, supra, at 490.

The implied covenant to market is an acceptable tenet of oil and gas law. West, id. at 491. West is an example of the application of the implied covenant to market. North Dakota aligned itself with Kansas, Colorado, Oklahoma and Arkansas in West, applying the implied covenant of marketability without the needless analysis employed by the lower federal courts which favor the respondent oil companies and which constrains the oil and gas law of North Dakota.

The lease of the mineral estate is entered into for the mutual benefit of the parties, but not all

parties participate equally in the lease development decisions: that is non-working interest owners, "must defer" to risk bearing parties, that is, working interest owners, to decide where and when to drill, formations to be tested, and ultimately, whether to complete a well and establish production. Oil companies (respondents) contracting leases are free to allocate costs of compression, transportation, and processing in their lease agreement. The lessor retains only 1/8th royalty and the working interest the remainder and the position of the parties are not equal. Grimon v. Conoco, Inc., supra.

The District Court "fearlessly predicted" as to how the North Dakota Supreme Court would treat this issue (App. B, p 9). The District Court rather than making a fear-less prediction should have certified this issue to the Supreme Court of North Dakota. See Wood v. TXO Production, Corporation, supra; Garman v. Conoco, Inc., supra. The rights and obligation of the owner of royalty interests created by oil and gas leases are determined by reference to state law. Mineral Leasing Act §17, 30USC 226. The lower federal court is rendering a doubtful application of state law. The Supreme Court should grant certiorari. Bernhardt v. Polygraphic Company of America, (VT. 1956, 76 S. Ct. 273, 350 U.S. 198, 100 L. Ed. 199).

It constitutes a violation of the full faith and credit clause and the due process clause of the federal constitution where the federal courts conflict with the laws of the State of North Dakota. This has been clearly established and has been brought to the attention of both of the lower courts. U.S.Const. Art. 4 §1, Amend. 14. A misconstruction by the lower

federal courts of the North Dakota law allows bad law to be predicated to the state of North Dakota in the important interstate climate of oil and gas law. Petitioners ask that a Writ of Certiorari issue to the lower federal courts to reverse and remand for certification of this question to the Supreme Court of North Dakota.

CONCLUSION

The Court should grant the petition and reverse the decision below.

Respectfully submitted this 28 day of March, 1996.

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APPENDIX A

IN THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Docket No. 95-1895ND

Marion Hurinenko, individually, and as Trustee for the Marion Hurinenko Revocable Living Trust, as Trustee for the D. Steven Hurinenko Irrevocable Living Trust, as Trustee for the Jeffrey A. Hurinenko Irrevocable Living Trust, and as Trustee for the George Hurinenko Family Trust; Marjo P. Hurinenko, Trustee for the Marion Hurinenko Revocable Living Trust; Elane H. Hurinenko, individually, and as Trustee for the D. Steven Hurinenko Irrevocable Living Trust, as Trustee for the Jeffrey A. Hurinenko Irrevocable Living Trust, and as Trustee for the Elane H. Hurinenko Revocable Living Trust; Julia Hurinenko, individually, and as Trustee of the Julia Hurinenko Revocable Trust; D. Steven Hurinenko,	) Appeal from the United States District Court for the District of North Dakota.

individually, as Trustee for the Elane H. Hurinenko Irrevocable Living Trust, and as Trustee for the George Hurinenko Family Trust; Jeffrey A. Hurinenko, individually, as Trustee for the Elane H. Hurinenko Revocable Living Trust, and as Trustee for the George Hurinenko Family Trust,

Appellants,

v.

Chevron, USA, Inc.; William Herbert Hunt, Trust Estate; Warren Petroleum Co.; Toc-Rocky Mountains, Inc.; Petro Hunt, Inc.; MW Petroleum Corporation; Amoco Production Company; Gulf Oil Corporation,

Appellees.

Submitted: October 20, 1995

Filed: November 13, 1995

Before FAGG, LAY, and HEANEY, Circuit Judges.

FAGG, Circuit Judge.

In this diversity dispute over royalties from an oil and gas lease, Marion Hurinenko and his family, the lessors, appeal the district court's order granting summary judgment to various corporations and a trust, the lessees (collectively the "oil companies"). We affirm.

Under a 1972 lease, the oil companies have the right to mine for oil and gas on the Hurinenkos' land. Oil reservoirs were discovered on the land in 1977, and the oil companies began drilling wells. The oil reservoirs on the Hurinenkos' land contain "casinghead gas." As the oil wells pump oil from the ground, this gas is also produced. The casinghead gas at issue in this case is not pure natural gas and thus cannot be transported in natural gas pipelines or sold until the contaminating compounds are removed. Initially, the gas was "flared," that is, burned off at the well. Apparently due to environmental concerns connected with flaring, the North Dakota Industrial Commission entered an order restricting oil production until the wells were connected to a gas gathering and processing facility. In 1978, the oil companies completed a processing plant. Most of the gas produced at the plant is sold.

Since the beginning of gas production in 1978, the oil companies have paid the Hurinenkos royalties based on the plant's sales proceeds less costs. After

accepting the payments for fifteen years, the Hurinenkos brought this lawsuit in 1993 seeking damages and cancellation of the lease. The district court granted summary judgment to the oil companies.

On appeal, the Hurinenkos contend the lease is ambiguous and thus should be construed against the oil companies. The Hurinenkos contend they are entitled to royalties based on the processing plant's gross proceeds without any deduction for processing costs. We reject the Hurinenkos' contentions.

The lease gives the oil companies the exclusive right to develop oil and gas on the land in exchange for royalties paid to the Hurinenkos. In the lease's third royalty provision, the lessees agree to pay royalties based on the "market value at the well for gas produced from any oil well and used off the premises." This provision applies because the casinghead gas is "produced from [an] oil well and used off the premises." Thus, the lease requires the oil companies to pay the Hurinenkos royalties based on the gas's "market value at the well."

This term has a well-recognized meaning in North Dakota. The North Dakota Supreme Court calculates market value at the well by the "work-back" method: deducting processing costs from gross sales revenues. Koch Oil Co. v. Hanson, 536 N.W. 2d 702, 707 (N.D. 1995); Amerada Hess Corp. v. Conrad, 410 N.W. 2d 124, 127 n.3 (N.D. 1987). Application of the work-back formula is particularly appropriate in this case. The gas had no readily discernible market value at the well before the incursion of processing costs to separate the compounds. Indeed, in 1980 the state tax

commissioner and the oil companies agreed to use the work-back method to calculate the gas's wellhead value for the purpose of state gas gross production taxes.

The established meaning of "market value at the well" distinguishes this case from West v. Alpar Resources, Inc., 298 N.W. 2d 484, 490-91 (N.D. 1980), on which the Hurinenkos rely. In West, the royalty provision stated the lessor would receive part of "the proceeds from the sale of the gas" and the court found the term "proceeds" was ambiguous. Id. at 487. The West court distinguished cases like this, in which the royalty obligation is to be decided "at the wellhead." Id. at 488.

Accordingly, we affirm the district court.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS,
EIGHTH CIRCUIT.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF NORTH DAKOTA
SOUTHWESTERN DIVISION

Marion Hurinenko Revocable Living Trust, et al

Plaintiffs,

v. A1-93-149

Chevron U.S.A., Inc. et al

Defendants.

MEMORANDUM AND ORDER

Both parties have moved for summary judgment in this revisiting of many of the issues presented to the North Dakota Supreme Court in West v. Alpar Resources, Inc., N.D., 298 N.W.2d 484. Those issues involve the interpretation of oil and gas leases, where it appears that the initial "producers" used an inappropriate lease form. The printed form was designed and intended for use in areas where the gas produced by operating oil wells was "sweet" gas, usable and sellable without processing. The gas produced in the Little Knife field, the area involved here, is "sour" gas and is highly poisonous and corrosive until treated.

A "sweet gas" lease authorizes the use of the gas at the well head to power pumping equipment and authorizes the land owner to use gas from the wellhead for home heating use. It provides for a royalty payment of 1/8 of the "market price" at the wellhead for gas "used off of" the premises, which one assumes would be that moving into the pipelines for sale as fuel as well as "used" for other purposes such as fuel for compression stations.

"Sour" gas, with some very few exceptions, cannot be used for pump powering or home heating purposes, until it is treated. "Sour" gas may or may not even have a "market value" at the wellhead, (a fact which was apparently stipulated to in West, although disagreed with in the concurring opinion) as it is not usable until collected through a pipeline system, transported to a processing plant, and processed. The process results in a portion of the gas being used to operate the plant and any compression stations required to move it through the pipeline, a portion converted to by-products, such as propane and sulphur, and the remainder then available for sale as fuel at the "tailgate" of the processing plant. By inference at least, a proper "sour" gas oil and gas lease should provide for a sharing of the costs of the gathering system, the compression plants, the treatment plants and process, and allocate ownership interests in the gas metered through the tailgate and the sale of the byproducts of the processing. Such lease language would hopefully be very specific, as the computation methods of deductible costs could vary substantially. Such an appropriately drawn lease should also define

the costs of production as distinct from the gas treatment, as production costs of the oil go with the 7/8ths royalty.

The lease involved was signed in 1972. When the Little Knife field was initially developed, the gas was "flared" at the wellhead and not collected and used. Eventually a gathering system and processing plant or plants were built, and a requirement imposed that prohibited flaring, leading to the operation of the field in a manner apparently not contemplated by the original lease agreements. Without the gathering system and processing plant, the wells could not be produced. (Does the Public Service Commission requirement that the gas be gathered and treated or the well shut-in convert the treatment costs to production costs?)

The complaint appears to seek payment for all amounts of gas used to power the compressors and processing plant, payment for 100% of the proceeds received for all byproducts of the processing operation, reimbursement for all other deductions from proceeds taken to defray the expenses of gathering and processing, in the alternative for conversion of all gas production, and for cancellation of the leases. The complaint recites that the expense of processing deductions for the period 1980 through 1993 is in the million of dollars, before the assessment of statutory interest at 18% and after interest, the damage claim is in the many millions of dollars, from this 9 or 10 producing wells involved.

The lease provisions relating to royalty payments for natural gas provide:

second: The lessee shall pay lessor, as royalty, one-eighth of the proceeds from the sale of the gas, as such, for gas from wells where only gas is found...

third: To pay lessor one-eighth (1/8) of the market value at the well for gas produced from any oil well and used off the premises....

As noted above, the lease language does not fit the situation -- the wells involved here were not solely gas wells, so "second" is inapplicable, and using "third", literally all of the gas produced was "used off the premises" if that term also includes the gas sold as fuel at the plant tailgate, but the clause refers to "market value" and not "proceeds", and "sour" gas has no market without a gathering system and processing plant. The plaintiffs seek to substitute "proceeds" for "market value" in the royalty clause, and to recover back all charges made by the producer against the gross "proceeds".

The initial reaction of the court is to conclude that "third" applies and that the "market value" of the sour gas at the wellhead is the sale proceeds received after processing, less the additional costs of gathering and processing. Market value would appear to equate with net proceeds, and it further appears that this is what the plaintiffs have been paid. There may be major quarrels with the methodology of computing the costs of processing in the absence of any agreement between the parties, but this action does not challenge the computation method, only its use at all.

Plaintiffs, in reliance upon West, choose to ignore the fact that the operative language in West

was "1/8th of the proceeds from the sale of the gas."[1] The case turned on the interpretation of the term "proceeds." Here the lease provides for "1/8th of the market value at the well for any gas produced from an oil well and used off the premises" so while West provides a very scholarly comparison of the position of the various text pundits on oil & gas law and case law, it does not control the outcome of this action.

The court would note another complicating factor in that plaintiffs argue that the percentages of gas used to create by-products and also that sold at the plant tailgate - the majority of the gas produced -- in their opinion does not constitute gas "used" and that therefore they are entitled to 100% of it, not just a 1/8th interest. Unfortunately, that interpretation overlooks the fact that the lease then contains no obligation on the part of the producer to pay them anything at all for such gas, which might not produce the desired result.

No attempt will be made to rewrite West. It was very well done the first time, and highlights the various legal principles necessary for the result reached in interpreting the specific language before the court. The Hurinenko language is different. The West court determined:

1. an ambiguous mineral lease will be interpreted against the position of the party most able to dictate

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[1]West v. Alpar Resources, Inc., 298 N.W.2d 484 at 486, (N.D. 1980.)

and control its terms -- the producer or developer usually;[2]

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[2]Id., at 490-491. See also Filmore v. Superior Oil Company, 192 Kan. 388, 388 P.2d 602 (1964), which West adopts where the Kansas Supreme Court states the following:

> "Construction of oil and gas leases containing ambiguities is in favor of the lessor and against the lessee for the reason that the lessee usually provides the lease from or dictates the terms thereof and if such lessee is desirous of more complete coverage, the lessee has the opportunity to protect itself by the manner in which it draws the lease." 388 P.2d at 603."

and

Ladd v. Upham, 58 S.W.2d 1037 (Tex.Civ.App. 1933), aff'd, 128 Tex. 14, 95 S.W.2d 365 (1936) which the West Court fully agreed with where Thorton's treatise on the Law of Oil and Gas, was quoted:

> "The lessor usually knows nothing of the law applicable to such instruments; while the operator is usually well informed. Years of experience have shown the operator how to draw a lease giving him many advantages, of which the lessor has not even thought. For this reason the courts have adopted a rule to the effect to construe an oil or gas lease most

2. each lease is unique if using different terms, and therefore each consideration is primarily fact driven;[3]

3. the 7/8th interest carries with it the obligation to pay the costs of production;[4]

> favorable to the lessor, where its terms can be so construed without doing violence to the language used." 58 S.W.2d at 1039."

[3]West, 298 N.W.2d at 490.

[4]Warfield Natural Gas Co. v. Allen, 261 Ky. 840, 88 S.W.2d 989 (1935) as cited by West at 298 N.W.2d at 488, stated:

> "Defendant had the exclusive right to produce the gas and to market the gas. It was as much its duty to find the market as to find the gas. Nothing is said about its expenses in doing either. It must be presumed that the payment by the defendant of its expenses in doing both is the consideration it is to pay for its seven-eights of the proceeds, for it pays no other and it certainly gets the lions share. ... 88 S.W. 2d at 991"

Further guidance was provided by 3 Williams, Oil and Gas law, pp. 591-603 (1979); 3 Kuntz, Law of Oil and Gas, pp. 319-327 (1967); Merill, Covenants Implied in Oil and Gas Leases, pp. 212-218 (2nd Ed.

4. the lease holder has an obligation to operate the well in a commercially reasonable fashion, and with the rules laid down by the Public Service Commission, the producer was required to gather and process gas in order to produce anything at all, therefore it is not unreasonable to require the producer to stand the cost of construction of gathering system and treating plant;

5. if the drafter of an oil and gas lease wanted the term "proceeds from sale of gas" to be a net after capitalization costs and after processing plant expenses, then it was the obligation of the drafter to so state and in the absence of any such language -- "proceeds" means what one gets when the product is sold -- gross rather than net.[5]

1940).

> "The authors of these treatises are in apparent agreement that there is an implied duty upon the lessee under an oil and gas lease to bear the entire expense of "production." They are also in apparent agreement that, unless there is an express provision in the lease to the contrary, the costs of "processing" are to be shared by the lessor and the lessee." West v. Alpar Resources, Inc., N.D., 298 N.W.2d 484 at 489.

[5]West, 298 N.W.2d at 491.

The North Dakota court did not and has not considered the lease language presented here. This court fearlessly predicts the North Dakota Court would reach the following results in addition to the principles of West:

1. "Third" fits better than "second" and "Market price at the well" does not mean "proceeds" as used in West. Common sense requires that market value at the well be computed by adding the proceeds from the sale of gas at the plant tailgate and the proceeds from sale of by-products, and from that total deducting some commercially reasonable computation of the costs of putting the product into sellable form.

2. "used off of the premises" means all gas metered in transit off of the well site. The value of and deductions for gas used to operate the processing plant results in a "wash" for both sides, and it is immaterial whether it is included or excluded.

3. the method of calculating the deductible costs from the gross proceeds of by product and gas at the plant tailgate is subject to some very real questions, involving definitions of production costs and analysis of the capital investment requirements of producers under the obligation to operate the wells in a commercially reasonable manner.

4. Cancellation of the lease would not be an appropriate equitable remedy under the facts

presented, and in all events the doctrine of laches would apply to protect the leasehold interest.

The defendants are entitled to summary judgment of dismissal, with prejudice, of the plaintiff's complaint, but that dismissal would not cover the issue specifically not litigated herein, namely the commercial reasonableness of the deductions taken for gathering and processing costs of the gas.

SO ORDERED

Dated this 13th day of March, 1995.

Patrick A. Conmy, District Judge,
United States District Court

APPENDIX C

UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Docket No. 95-1895NDBI

Marion Hurinenko, etc., et al, Appellants,	)
	) Appeal from the) United States) District Court for) the District of) North Dakota.
v.	)
Chevron, et al, Appellees.	)

The petition for rehearing filed by the appellant has been considered by the court and is denied.

January 3, 1996

Order Entered at the Direction of the Court:

Clerk, U.S. Court of Appeals, Eighth Circuit.

APPENDIX D

UNITED STATES DISTRICT COURT
District of North Dakota - Southwestern Division

Marion Hurinenko
Revocable Living
Trust, et al.,

v.

JUDGMENT IN A CIVIL CASE

Chevron U.S.A.,
Inc., et al.,
et al.,

Case Number: A1-93-149

Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that the defendants motion for summary judgment is granted and the above entitled action is dismissed with prejudice.

NOTICE OF ENTRY this 13th day of March 1995.

March 13, 1995
Date

Edward J. Klecker
Clerk

Supreme Court, U.S.
FILED
MAY 1 1996
CLERK

No. 95-1581

In The

Supreme Court of the United States

October Term, 1995

MARION HURINENKO, *et al.*,

Petitioners,

vs.

CHEVRON U.S.A., INC., *et al.*,

Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

RESPONDENTS' BRIEF IN OPPOSITION

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1799

QUESTION PRESENTED

Whether the District Court for the District of North Dakota and the Eighth Circuit Court of Appeals correctly applied North Dakota law in determining that, for purposes of payment of royalties, the "market value at the well" of gas can be determined by deducting processing costs from the gross proceeds received for the sale of gas and other products at the tailgate of the processing plant?

PARTIES TO THE PROCEEDING

Pursuant to Rule 29(6) of the Supreme Court Rules, the Respondents and, where applicable, their parent corporations and nonwholly owned subsidiaries are as follows:

Chevron U.S.A., Inc., Warren Petroleum Co., and their parent corporation, Chevron Corp.

The William Herbert Hunt Trust Estate, whose trustee is J.W. Beavers, Jr.

Petro Hunt Corporation

TOC-Rocky Mountains, Inc., Amoco Production Company, and their parent corporation, Amoco Corporation

MW Petroleum Corporation and its parent corporation, Apache Corporation

TABLE OF CONTENTS

	Page
Question Presented	i
Parties to the Proceedings	ii
Table of Contents	iii
Table of Citations	iv
Statement of the Case	1
Reasons for Denying the Writ	2
I. Both the district court and the appellate court properly applied North Dakota law to the dispute involving the interpretation of a contract relating to real property located in the State of North Dakota.	2
II. Neither the District Court for the District of North Dakota nor the Eighth Circuit Court of Appeals erred in failing to certify any question to the North Dakota Supreme Court.	6
III. In any event, Petitioners have not established, and there do not exist, any "compelling reasons" for granting certiorari in this case.	9
Conclusion	11

Contents

Page

TABLE OF CITATIONS

Cases Cited:

Amerada Hess Corp. v. Conrad, 410 N.W. 2d 124 (N.D. 1987) 4,5,8

Brockett v. Spokane Arcades, Inc., 472 U.S. 491 (1985) ... 10

Butner v. United States, 440 U.S. 48 (1979) 10

Huddleston v. Dwyer, 322 U.S. 232 (1944) 10

Koch Oil Co. v. Hanson, 536 N.W. 2d 702 (N.D. 1995) .. 8

Lehman Brothers v. Schein, 416 U.S. 386, 94 S. Ct. 1741, 40 L. Ed. 2d 215 (1974) 7,8

Piney Woods Country Life School v. Shell Oil Company, 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005, 105 S. Ct. 1868, 85 L. Ed. 2d 161 (1985) 4,5,8

West v. Alpar Resources, Inc., 298 N.W. 2d 484 (N.D. 1980) 2,3,4,5,6,7,8,9

Statutes Cited:

28 U.S.C. § 1332 2

28 U.S.C. § 1254(1) 2

Contents

Page

Rules Cited:

North Dakota Rule of Appellate Procedure 47 ..... 7, 8

North Dakota Rule of Appellate Procedure 47(a) 7

North Dakota Rule of Appellate Procedure 47(b) 7

Supreme Court Rule 10 9

Supreme Court Rule 19(1)(b) 9, 10

STATEMENT OF THE CASE

This action involves the interpretation of, and payment of gas royalties under, a 1972 oil and gas lease covering lands in North Dakota. The gas in question is produced together with oil from a number of wells, and is taken from the various wells to a central processing plant where hydrogen sulfide and various liquid hydrocarbons are removed from the raw gas stream. Sulfur, various liquid hydrocarbons such as propane, and "residue" or "dry" gas are then sold at the tailgate of the plant. (Pet., p. 2b). The Respondents are working interest owners, or lessees, under the oil and gas lease in question and are also owners of the gas processing plant. Under the oil and gas lease, the Petitioners, who are mineral owners, or lessors, are entitled to royalties of one-eighth of the "market value at the well" of the gas.[1] (Pet., p. 4a).

Since 1978, when production first began under the lease, the Petitioners have been paid royalty in accordance with what has been described as the "work-back method" — that is, gross proceeds at the tailgate of the plant less the costs of gathering, treating and processing the gas. (Pet., p. 3a). In 1993, after accepting royalties calculated in accordance with this method for 15 years, the Petitioners commenced this action, asserting that they should have been paid royalties on the gross value at the tailgate of the plant. (Pet., p. 4a). Petitioners seek to be paid not on the "market value at the well," but on the "market value at the tailgate of the plant," after value has been added by gathering, treating and processing.

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1. The Petitioners previously asserted that they were entitled to royalty based on one-eighth of the "proceeds from the sale of the gas" under a provision of the royalty clause applicable to gas "from wells where gas only is found." The district court rejected this contention (Pet., p. 9b), as did the court of appeals (Pet., p. 4a). The Petitioners have apparently abandoned this claim.

This action was commenced in state district court, then removed to the District Court for the District of North Dakota on the basis of diversity jurisdiction under 28 U.S.C. § 1332. The district court granted summary judgment dismissing the petitioners' complaint. On appeal, the court of appeals affirmed the action of the trial court. Petitioners have now filed a petition for writ of certiorari under 28 U.S.C. § 1254(1).

REASONS FOR DENYING THE WRIT

I.

BOTH THE DISTRICT COURT AND THE APPELLATE COURT PROPERLY APPLIED NORTH DAKOTA LAW TO THE DISPUTE INVOLVING THE INTERPRETATION OF A CONTRACT RELATING TO REAL PROPERTY LOCATED IN THE STATE OF NORTH DAKOTA.

In their effort to obtain review before this Court, the petitioners have mischaracterized the status of North Dakota law relating to the deduction of processing costs in determining "market value at the well." Petitioners assert that the "thrust" of *West v. Alpar Resources, Inc.*, 298 N.W. 2d 484 (N.D. 1980), is that "when a lease does not state otherwise lessors are entitled to royalty payments based on a percentage of total proceeds received by the lessee, without deduction for costs." (Pet., p. 5).

In *West*, the applicable lease provision required the payment of royalty not on the basis of "market value at the well," but on the basis of "the proceeds from the sale of gas, as such." 298 N.W. 2d at 486. The North Dakota court reviewed cases from various jurisdictions holding that royalty payments were subject to a variety of deductions and cases from other jurisdictions determining that such deductions may not be made. Contrary to

the assertion of the petitioners that the court in *West* "aligned itself with Kansas, Colorado, Oklahoma and Arkansas [by] applying the implied covenant of marketability" (Pet., p. 6), the North Dakota court expressly declined to decide the issue, stating as follows:

> Although the foregoing authorities provide background and helpful insight, we must ultimately decide this case upon the express language of the lease using appropriate rules for interpreting contractual agreements.

Id., at 490.

The court then determined that the term "proceeds" was ambiguous because rational arguments can be made both in support of the view that the term means "gross proceeds" and the view that the term means "net proceeds." *Id.* Noting that an ambiguous oil and gas lease should be construed against the lessee, the North Dakota court said as follows:

> We do not believe it is necessary in the instant case to attempt to determine whether expenses relating to the extraction of hydrogen sulfide or other expenses incurred by Alpar in marketing the gas fall within the category of "production expenses" or "processing expenses." Nor do we find it appropriate to determine whether or not the lease impliedly placed the royalty obligation at the well head rather than at the point of sale. Consistent with our view that the lease must be construed most strongly against Alpar, we conclude that the Wests are entitled to royalty payments based upon a percentage

> of the total proceeds received by Alpar from the sale of the gas without deduction for the cost of extracting hydrogen sulfide and without deduction for any other costs incurred by Alpar.

Id. at 491.

Some seven years after deciding *West*, the North Dakota Supreme Court addressed the issue of the determination of "gross value at the well" for purposes of North Dakota's gross production tax on oil and gas. In *Amerada Hess Corp. v. Conrad*, 410 N.W. 2d 124 (N.D. 1987), the North Dakota court affirmed the use of a "work-back" method, under which the costs of transportation, processing and treatment are deducted from the ultimate proceeds of sale, in order to determine "gross value at the well." The North Dakota court noted that the phrase "gross value at the well" was stipulated by the parties to mean the "fair market value of the gas." 410 N.W. 2d at 128. In determining that the work-back method was an appropriate method of valuation, the court relied, in part, upon *Piney Woods Country Life School v. Shell Oil Company*, 726 F.2d 225, 233 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005, 105 S. Ct. 1868, 85 L. Ed. 2d 161 (1985). 410 N.W. 2d at p. 129.

In *Piney Woods*, the Fifth Circuit Court of Appeals, applying Mississippi law, stated as follows:

> We agree with Shell that the specification in the leases that the royalty is computed "at the well" controls. In Part III of this opinion, we discuss the purposes of distinctions between "amount realized" and "market value at the well." We concluded that "at the well" refers not only to the place of sale but also to the

> condition of the gas when sold. "At the well" means that the gas has not been increased in value by processing or transportation. It has this meaning in conjunction with "value" or "amount realized" as well as with "sold." The lessors under these leases are therefore entitled to royalty based on the value or price of unprocessed, untransported gas. On royalties "at the well," therefore, the lessors may be charged with processing costs, by which we mean all expenses subsequent to production, relating to the processing, transportation, and marketing of gas and sulfur.

726 F.2d at 240 (citations omitted).

Thus, *West* does not hold that "when a lease does not state otherwise lessors are entitled to royalty payments based on a percentage of total proceeds received by the lessee, without deduction for costs." (Pet., p. 5). It holds only that when royalties are payable on the basis of a "proceeds" royalty clause, with nothing to indicate whether such proceeds are "net" or "gross", no deduction may be made from the proceeds received by the producer, or lessee, for the cost of extracting hydrogen sulfide.

Instead, the North Dakota court, when determining the "gross value at the well" of gas, which it accepted as meaning the fair market value of the gas, specifically relied on the work-back method approved in *Piney Woods*. *Amerada Hess*, *supra*. Under that method, when royalties are payable "at the well", lessors may be charged with processing costs, meaning all expenses subsequent to production, relating to the processing, transportation, and marketing of gas and sulfur.

The district court properly applied this North Dakota law. It noted that the petitioners, in attempting to rely on *West*, chose "to ignore the fact that the operative language in *West* was "1/8th of the proceeds from the sale of the gas" as opposed to "1/8th of the market value at the well" in the instant case. (Pet., p. 5b). It then said:

> Common sense requires that market value at the well be computed by adding the proceeds from the sale of gas at the plant tailgate and the proceeds from sale of by-products, and from that total deducting some commercially reasonable computation of the costs of putting the product in a sellable form.

(Pet., p. 9b).

The court of appeals similarly distinguished the "proceeds" royalty clause of *West* from the "market value at the well" clause in this case and recognized the North Dakota Supreme Court's adoption of the "work-back" method. (Pet., p. 5a).

II.

NEITHER THE DISTRICT COURT FOR THE DISTRICT OF NORTH DAKOTA NOR THE EIGHTH CIRCUIT COURT OF APPEALS ERRED IN FAILING TO CERTIFY ANY QUESTION TO THE NORTH DAKOTA SUPREME COURT.

Petitioners imply that the district court, and perhaps the Eighth Circuit Court, should have certified a question to the North Dakota Supreme Court.[2]

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2. Petitioners do not even attempt to explain the apparent inconsistency

(Cont'd)

The North Dakota Supreme Court has adopted, as Rule 47 of the North Dakota Rules of Appellate Procedure, the Uniform Certification of Questions of Law Act, which provides that the Supreme Court may answer questions of law certified to it by the Supreme Court of the United States, a Court of Appeals of the United States, the United States District Court, or the highest appellate court or an intermediate appellate court of any other state "if there are involved in any proceeding before it questions of law of this state which may be determinative of the cause then pending in the certifying court and as to which it appears to the certifying court there is no controlling precedent in the decisions of the Supreme Court of this state." Rule 47(a), North Dakota Rules of Appellate Procedure. The rule may be invoked either upon a court's own motion or upon the motion of any party to the cause. Rule 47(b), North Dakota Rules of Appellate Procedure.

This Court has indicated its reluctance to substitute its judgment for that of the district court or the court of appeals on matters of certification:

> We do not suggest that where there is doubt as to local law and where the certification procedure is available, resort to it as obligatory. . . . Its use in a given case rests in the sound discretion of the federal court.

Lehman Brothers v. Schein, 416 U.S. 386, 390-391, 94 S. Ct. 1741, 40 L. Ed. 2d 215 (1974).

There are several reasons why certification of any question is not required in this case.

(Cont'd)

between this argument and their argument that *West* is controlling in this case. Indeed, in suggesting that a question should have been certified, the Petitioners acknowledge the inapplicability of *West v. Alpar Resources, Inc.* to this case.

First, North Dakota law is not particularly doubtful. By its own terms, Rule 47 of the North Dakota Rules of Appellate Procedure applies only when it appears that "there is no controlling precedent in the decisions of the supreme court of this state." In *Lehman Brothers*, *supra*, the court of appeals specifically determined that Florida law, which was controlling was not "decisive." 416 U.S. at 389. This Court couched its discussion of the duty to certify in terms of "doubt as to local law."

In this case, North Dakota law is not particularly doubtful, but is instead relatively clear. *West*, a "proceeds" case, is inapplicable to a "market value at the well" case. *Amerada Hess* involved the determination of "gross value at the well" for purposes of gross production taxes, rather than the "market value at the well" for purposes of royalty, and so is not "controlling." However, the North Dakota court in *Amerada Hess* noted that "gross value at the well" meant "fair market value of the gas" (410 N.W. 2d at 128), and further noted that the same general interpretation rules govern both the interpretation of statutes and contracts such as oil and gas leases. 410 N.W. 2d at 130, n. 6. The North Dakota Court more recently reaffirmed the holding of *Amerada Hess* in *Koch Oil Co. v. Hanson*, 536 N.W. 2d 702 (N.D. 1995). Under *Piney Woods*, as relied upon by the court in *Amerada Hess*, there is no doubt but that the expenses of processing, transportation and marketing may be deducted in determining the value of gas "at the well." *See Piney Woods*, 726 F.2d at 240.

Second, the petitioners at no time requested either the district court or the court of appeals to certify any question to the North Dakota Supreme Court. As noted above, Rule 47 of the North Dakota Rules of Appellate Procedure specifically provides that the rule may be invoked either upon the court's own motion or upon the motion of any party to the cause. Petitioners

apparently made a strategic decision not to seek certification of a question, but instead to rely upon their less than well-founded argument that *West v. Alpar* controlled this case.

III.

IN ANY EVENT, PETITIONERS HAVE NOT ESTABLISHED, AND THERE DO NOT EXIST, ANY "COMPELLING REASONS" FOR GRANTING CERTIORARI IN THIS CASE.

Under Rule 10 of the Supreme Court Rules, a petition for writ of certiorari "will be granted only for compelling reasons." Rule 10 specifically includes three examples of the character of the reasons the court considers in reviewing petitions for certiorari:

> (1) a conflict between the decisions of two courts of appeals on an important matter, or a conflict between the decision of a court of appeals and a state court of last resort on an important federal question, or a departure by a court of appeals such as calls for an exercise of the supreme court supervisory power;
>
> (2) a decision by a state court of last resort on an important federal question that conflicts with another controlling state court decision or a decision of a court of appeals;
>
> (3) a decision by a state court or court of appeals on an important question of federal law that has not been decided by the supreme court or in such a fashion that conflicts with the relevant decision of the supreme court.

Prior to the revision of the Supreme Court Rules in 1980,

Rule 19(1)(b) included as a specific consideration for granting review on certiorari, a court of appeals' decision that resolved "an important state or territorial question in a way in conflict with applicable state or territorial law."

This case does not involve any questions of federal law, nor does it involve any question as to whether federal or state law should apply. This case involves purely the application of state law to a contract dispute.

The expertise of the courts of appeals as to matters of local law of the states within their circuits has previously been recognized. *See Butner v. United States*, 440 U.S. 48, 57-58 (1979); and *Brockett v. Spokane Arcades, Inc.*, 472 U.S. 491, 499-500 (1985).

> [O]rdinarily we accept and therefore do not review, save in exceptional cases, the considered determination of questions of state law by the intermediate federal appellate courts.

Huddleston v. Dwyer, 322 U.S. 232, 237 (1944).

CONCLUSION

Because the courts below correctly applied North Dakota law to this contract dispute, and because, in any event, there are no "compelling reasons" for granting the writ of certiorari, the petition should be denied.

Respectfully submitted,

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